How to Protect Yourself from the Coming Inflation

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The mugger, the armed robber and the hit man are knocking at your door. All around the world, governments have resorted to money printing. It’s an activity long thought to be taboo because of its disastrous inflationary effects. Time and time again, inflation has been proven to destroy entire economies and vast amounts of wealth. What are you going to do about this threat?

This report will outline some strategies and actions to protect yourself and your wealth from inflation. The report will focus on Australia’s unique position amongst the flailing economies of the world.

But first, is the threat of inflation really all that serious?

The Power of Inflation

The dangerous effects of inflation could fill many volumes of books. As could the stories of inflationary episodes. Over and over again, inflation has destroyed some of the world’s most prosperous and powerful countries and even civilisations. But what is the effect of inflation on your wealth? What is the threat you face now?

Inflation wipes out certain types of wealth. (It can actually enhance other types.) Here is a quick guide to the effects of inflation on various asset classes:

1. Cash and Savings

Obviously, money under a mattress will lose value at the rate of inflation. But money in your savings account isn’t safe either. That’s because interest rates don’t usually keep up with the rate of inflation. Only the most determined central bankers dare to raise interest rates to the levels needed to stop inflation once it has broken out.

So what does the effect of inflation on your cash look like in the real world? Well, in 1913 an egg cost about 8 Pfenning in Germany. Ten years later, it cost 80 billion Mark. Cash had to be wheeled around in wheelbarrows. Savings didn’t count for much.

2. Bonds

It’s not just cash that loses value. Any asset directly linked to a currency is in danger too. The most important of these assets are bonds. Governments and corporations use bonds to finance themselves. They are essentially loans, but can be bought and sold by investors.

The global bond market is almost twice the size of the global equity market. Arguably, it’s far more important. But inflation is the bond market’s worst nightmare. The only thing worse than holding cash during an inflationary period

‘The age of credit expansion, which led to double-digit portfolio returns, is over. The age of inflation is upon us, which typically provides a headwind, not a tailwind, to securities price — both stocks and bonds.’
- Bill Gross, Co-chief Investment Officer of Pimco
is holding a claim on cash in the future. And that’s what a bond is — a promise to pay.

Bond investors have been devastated many times in the past. Inflation, by its nature, is rarely reigned in once it gets bad. Because of this, bond investors anticipate that the money they receive in the future won’t be worth much and begin to sell their bonds. The resulting panic can see bond prices to crash at a much faster pace than the rate of inflation.

Some bonds are ‘inflation linked’. The idea is that their interest rate takes into account the rate of inflation. But one characteristic of serious inflations is that governments stop reporting honest figures, and that can compromise inflation protected bonds.

### 3. Shares

What’s surprising is that shares don’t necessarily do well during inflation. Conventional wisdom is that shares go up with inflation. Because companies can raise their prices, and share prices can rise, both should keep up with inflation at the very least. And they often do, but not necessarily to the extent of protecting your wealth.

Inflationary episodes are bad for the economy. They create all kinds of inefficiencies and imbalances. For example, people spend their time trying to spend their cash as quickly as possible instead of working. That means there aren’t any savings to invest in economic production. A poorly performing economy usually translates to poor share prices, because companies become less profitable.

Truly severe hyperinflations illustrate the importance of this point. They can completely wipe out stock market wealth. The Weimar inflation saw the German stock index rise from 88 to 26,890,000,000. But it still lost 97% of its purchasing power in real terms! In other words, consumer prices went up more than share prices.

Shares are certainly preferable to bonds and cash under inflationary circumstances. Just remember that they are no automatic solution to the problem. The other factors at play in the stock market continue to be crucially important. Your investment strategy and individual stock choices matter just as much as ever.

### 4. Property

As for property, this tends to be a safe haven from inflation. But not necessarily, because property can be overvalued when inflation first gets out of hand. Still, over long periods of inflation, property should hold its value. And rents tend to keep pace as well.

### 5. Precious Metals

Owning precious metals is the traditional way to protect yourself from inflation. Gold and silver have held their value over thousands of years. In fact, many people perceive gold to be the real money of the world. That’s because government mandated money isn’t actually worth anything. Eventually, people lose faith in it and return to gold. Usually that moment occurs during high rates of inflation, creating the perfect storm for the gold price to skyrocket.

That’s what happened during the Weimar Hyperinflation in Germany after the First World War.
The gold price started out at 100 marks, hit 2000 within a year and 87 trillion marks before the hyperinflation was over. It might sound completely surreal to have that level of inflation. But reality on the streets included cash being burnt for warmth. As for gold investors, the gold price rose 1.8 times the level of inflation, leaving them with a gain in real terms.

Other precious metals can benefit from inflation as well. For example, if the world experiences a strong economic recovery, that can lead to inflation. Under these circumstances, precious metals with industrial uses, like silver, could benefit from inflation and industrial demand. You don’t have to be gloomy about the future to benefit from precious metals.

6. Income

The most valuable part of your wealth is your ability to earn income. Because wages tend to rise with inflation, this part of your wealth may already be inherently protected from it. But just how protected can differ a lot. A contractor, for example, can change his prices for each and every job, while a salary earner is often stuck for a year.

It’s people without income earning ability that have most to fear from inflation, unless they protect their wealth.

The Decline of Paper and the Rise of Real

The easiest way to think about the effects of inflation on different asset classes is to separate them into real and paper assets. Inflation destroys paper — or nominal — values, but doesn’t impact the value of real things. It reduces the value of cash and bonds, but assets like property and precious metals don’t actually change. They just keep on being property and metal. Your ability to work and earn money is very much a real thing, because you are physically doing it. That’s why wages tend to rise with inflation.

An interesting twist on this is that inflation reduces the difficulty of paying debt for those with real wealth. That’s because debt, like bonds, is expressed in dollar terms. As dollars are easier to come by, debts are easier to pay. This explains one of the advantages of owning property during high inflation periods. Most people borrowed money to buy it.

Now that you know how your wealth could be impacted by inflation, why not take stock of your wealth and whether it is real or nominal? How much of your hard earned assets could stand up to an inflationary bout? Chances are, you’re part of of the overwhelming majority of people relying on monetary stability.

So what evidence is there that we may see a period of monetary instability in the future?

The Coming Inflation

‘The Monetary Endgame Score To Date: Hyperinflations: 56; Hyperdeflations: 0’
- Zero hedge

‘They are printing trillions of dollars’ used to be a scaremonger’s metaphor for loose monetary policy. Now it’s the official policy of central banks all around the world. They have, out of thin air, created unimaginable sums of money. And with more money comes higher prices.

The famous Weimar hyperinflation of the 1920s has had a lasting effect on Germans. Even today, primary school children learn a rhyme about how an increase in the money supply is a
decrease in the value of money.

Unfortunately, it’s not that simple. The amount of money in the economy is only half the equation. How quickly it moves is the other crucial factor. During the global financial crisis, people stopped spending and banks stopped lending. This slowed down the ‘velocity’ of money, causing prices to fall.

### Velocity of Money

![Velocity of Money Graph](Source: Econbrowser)

The money printed by central banks managed to offset this slowdown, giving us a fairly stable price level overall.

### Money Supply

![Money Supply Graph](Source: Econbrowser)

But what happens when velocity begins rising again? All that money central banks created will start to slosh around the system at an increasing pace. And that could unleash the inflation of a lifetime.

Central bankers say they can reduce the amount of money in the system as velocity picks up. They call it their ‘exit plan’. But this time, they could fail. The reason why lies in the level of government debt around the world. Without vast amounts of government debt, and vast government deficits, inflation couldn’t really take hold.

You see, if inflation begins to rise and central bankers attempt to implement their exit plans, they will encounter an obstacle. Interest rates have to rise as part of their exit plan. They need to offset the inflationary policies of the past. But with rising interest rates come rising interest bills.

The last time this happened was in the 1970s. American central banker Paul Volcker had to raise interest rates to 20% before inflation was put in check. That had quite an effect on people who had interest bills to pay. People literally hanged effigies of him in the street. But the policy worked and inflation fell.
**This Time is Different**

Today, American government debt is so vast, there is no way the budget could handle an interest rate half the 1970s level. And monetary policy has been far worse than it was in the 70s. In other words, the American government budget, along with many European government budgets, could get completely out of control if rates rise. This has already happened in much of Europe, although rates rose before inflation even hit. Economist and broker Peter Schiff, who predicted the 2008 financial crisis, calls the prospect of high interest rates the ‘real fiscal cliff’.

"On the current trajectory the national debt will likely hit $20 trillion in a few years. If by that time interest rates were to return to some semblance of historic normalcy, say 5 per cent, interest payments on the debt would then run $1 trillion per year. This sum could represent almost 40 per cent of total federal revenues in 2012!"

Under these circumstances, governments will turn to their central banks for a rescue. Having already rescued banks, car, and insurance companies, chances are the central banks of the world will oblige. The governments of Greece, the UK and many others already have been receiving bailouts to some extent. But here is the crucial point to understand. When a central bank begins funding a government, that is exactly the policy which creates the inflation in the first place. This is the point where inflationary cycles get out of hand. The more central banks help the government, the more inflation they create, the more help the government needs. The supposed cure is also the disease.

If you're confused, here's another way of looking at it. Central banks implement their policies by buying and selling government bonds. That's how they add and take out money from the economy. But as soon as they buy government bonds to support the government's finances, they have committed to an endless process of printing money. The more they help the government with freshly created dollars, the higher inflation and interest rates go. And then the government needs more help.

If government debt is very low to begin with, the process can be brought to a screeching halt by high interest rates. But if the debt and deficits are so big that the higher interest rates only put the government into a bigger black hole, then the inflation will break out.

**So How Does Australia Fit Into All This?**

You might be wondering what the prospects of inflation in American and Europe have to do with Australia. Our government doesn't have anywhere near the debt and deficit concerns. Nor have we been printing money.

There are two ways we could nevertheless suffer from inflation. And a third scenario could see you benefit from foreign inflation, even if it never reaches our shores. Let's take the last possibility first.

The price of inflation proof assets can rise more than the rate of inflation. In Weimar Germany, the gold price rose almost twice as fast as other prices. That means an Australian investor can benefit by investing in traditional inflation havens, even if the inflation takes place elsewhere.

But what are the two ways inflation could make it to our shores?

Well, if there is high inflation overseas, the Australian dollar would strengthen. As foreign currencies fall in value because of inflation, the Aussie dollar rises. But Australian exporters wouldn’t like that. It would reduce their sales revenue from overseas. That’s why central banks often intervene in the exchange rate. The Swiss central bank recently pegged its currency to the Euro to offset the dramatically changing exchange rate. The problem with this is that it imports inflation from overseas.

If the Reserve Bank of Australia implements exchange rate targets, it will have to create money to maintain those targets. And that money will begin sloshing around the economy, creating inflation.
Unless the bank is willing to abandon the currency manipulation and throw the Australian exporters to the wolves, the inflation will continue. Our fate will be tied to that of Europe or America. The second scenario for inflation here at home comes straight from Europe. The Australian economy has many of the hallmarks of those parts of Europe which are struggling now, as well as some characteristics of Asian countries which experienced a similar crisis in the 1990s.

We have an overvalued currency, a property bubble, resource curse, a reliance on foreigners lending us money and a huge financial sector. If all of these were to correct to more normal levels, that would mean a crisis big enough to rival Europe’s. And it would force the Australian government to rescue many big corporations, just as they were rescued in American and Europe. Pretty soon, the government’s debt and deficit would resemble that of countries now in crisis.

If it seems far-fetched, consider a very similar thing happened to Spain. Government debt wasn’t a concern until the property bubble crisis broke out. Now it’s in the centre of Europe’s financial crisis.

How to Protect Yourself

So what can you do today to make shore up your wealth against Ronald Reagan’s mugger, armed robber and hitman?

1. Change how you value things to real, not currency, terms

When the value of money is changing, it becomes completely useless to think in terms of money. Your stocks might be going up dozens of percent a day without you really becoming any more wealthy. Instead, think in terms of real wealth. One option is gold.

For example, the drought which struck North America in 2012 sent grain prices soaring. But in terms of gold, grain prices were actually cheap. The same goes for petrol prices — they have steadily been falling in terms of gold. Many people predict stock market performance, not in terms of the quoted index amount, but how many ounces of gold the index is ‘worth’. Below is a chart of the Dow Jones Industrial Average Index represented in terms of ounces of gold:

You might notice that the Dow has a habit of returning to its average of around 3 ounces of gold before it begins a new bull market. That means the price of gold is set to go up, or the Dow has far to fall.
Whether it’s your overall wealth, your daily budget, or your investments, thinking in real terms can give you the cool head you need during inflationary periods. It makes the world seem a lot less chaotic when the prices you think in aren’t rising rapidly each day.

2. Don’t trust the government

Governments are in trouble when inflation brakes out. And desperate times call for desperate measures. It cannot be emphasised enough that the Australian government will not be any different. It will lie, cheat and steal. Here are some ways you can expect them to react to inflation.

- Government statistics will systematically be manipulated. The rate of inflation, the level of unemployment and much more can be adjusted by the government. The website Shadowstats.com maintains a statistical database for American economic data which uses the same statistical measures as used 30 years ago. By those standards, economic data has been much worse than official government statistics.
- Confiscation of strategic assets, especially gold, is something that governments frequently do during high levels of inflation. The American government did just this in the 1930s. And Australia still has a law on the books which allows the government to confiscate gold. In other words, there will be no warning.
- Inflation causes your income to creep into higher income tax brackets. And capital gains tax must be paid as assets rise with inflation.
- Government benefits don’t tend to rise with inflation. Make sure you don’t rely on them.

Remember at all times that it is the government which is dumping inflation on you. Do not expect your politicians to do what is obviously right, moral or reasonable.

3. Buy inflation proof assets

Having some part of your wealth in inflation proof assets will offset the effects of inflation on your wealth. Which assets you choose should differ based on your individual situation. But one thing everyone should keep in mind is that high inflation often follows a deflationary shock. Much of the world had that shock in 2008. Australia did not. At least not to the same extent. This means we may yet see a deflationary shock in the Australian economy before we get inflation.

It’s up to you whether you wait for the buying opportunity of this shock, or buy now and risk taking the hit which inflation proof assets might experience. One wise strategy used by several wealthy and savvy investors is to buy a fixed amount of precious metals each month. That way, any drop in precious metals prices means you can buy more (or more cheaply) while a rise makes you wealthier.

As for property, keep in mind that Australia’s housing is overpriced on any measure.

4. Be prepared for chaos

Don’t expect to enjoy seeing your inflation proof assets rise in price. Just as the financial crisis of 2008 spilled out into the real economy, inflation impacts everything. Even John Maynard Keynes, the economist in whose name much inflationary economic policy is conducted today, understood this:

‘As the inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery.’

‘There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.’
Being mentally prepared for these kinds of trials is crucial. But so is being physically prepared.

5. Self sufficiency

There are small changes to your lifestyle which you can make to both enhance your life and make it more inflation resistant. Here are some quick ideas:

- hold less cash
- produce some of your own food
- keep some of your wealth overseas
- make significant storage space available
- hold some of your wealth on hand (but not in cash)

Each of these combats some of the problems of inflation. Of course, only implement those strategies that are cost efficient and convenient for you. You’ll find they give you piece of mind, something others won’t have when inflation strikes.

6. Stay informed

There is a large community of people with the same worries, interests and opinions as you. Tapping into this resource can mean the difference between being prepared and being caught unawares. One great way to keep in touch is the newsletter you just subscribed to.

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Our goal is to present these ideas to you. They’re often unique and confronting. But that is the secret to investing. You absolutely must not blindly follow the crowd and must question every assumption. Looking at things differently is how we do this. Make sure to check out our website for the latest articles, commentary and updates on inflation and other stories. Don’t ever hesitate to join the conversation.

Regards,

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